INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

September 10, 2002

Number: **200252059**
Release Date: 12/27/2002
Index (UIL) No.: 263A.09-00, 263A.08-00
CASE MIS No.: TAM-105525-01

Director, Field Operations, LMSB

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's TIN:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =
X =

ISSUE(S):

1. Whether the choice of measurement dates used in the calculation of capitalized interest under § 263A(f) constitutes a method of accounting to which the provisions of sections 446 and 481 and the regulations thereunder apply.

2. Whether an item classified as tangible personal property for purposes of the definition of “section 1245 property” in § 1.1245-3 can ever constitute “real property” as defined in § 1.263A-8(c).

3. Whether components of tangible personal property and components of real property may combine to form a single unit of property within the meaning of § 1.263A-10.

4. Whether taxpayer’s method of determining its accumulated production expenditures on various measurement dates was proper.

CONCLUSION(S):

1. The choice of measurement dates used in the calculation of capitalized interest under § 263A(f) does not constitute a method of accounting under §§ 446 and 481. However, once measurement dates are selected and used to compute capitalized

interest for a taxable year, the doctrine of election restricts any subsequent change of those measurement dates for that taxable year.

2. Some items of property classified as tangible personal property for purposes of the definition of § 1245 property may be classified as real property for purposes of § 263A(f).

3. Components of tangible personal property and components of real property may not combine in a single unit of property under § 1.263A-10.

4. The taxpayer's method of using the percentage of total project costs excludable from the accumulated production expenditures at the end of the project to determine the amount of project costs excludable from the accumulated production expenditures on the various measurement dates throughout the project was improper.

FACTS:

The taxpayer is a member of an affiliated group that filed a consolidated return for calendar years 1997 and 1998. The principal business of the taxpayer is the distribution of X through a nationwide system of warehouses and distribution centers.

For taxable years 9412, 9512, 9612, and 9712, the taxpayer computed capitalized interest under § 263A(f) using the taxable year as its computation period, with monthly measurement dates. For taxable year 9812, the taxpayer switched to quarterly measurement dates without obtaining the consent of the Commissioner. During the examination of 9712 and 9812, the taxpayer sought to recalculate its capitalized interest for 9712 under § 263A(f) using quarterly measurement dates. The examiner objects that the taxpayer, having chosen to use monthly measurement dates to prepare its return, cannot subsequently change to quarterly measurement dates.

In January of 1996, the taxpayer began construction of a new headquarters. The cumulative costs for the headquarters project as of December 31 of 1998 totaled approximately $146 million. The headquarters facility was placed in service in April of 1999.

In July of 2000, the taxpayer received the results of a cost segregation study of the headquarters project. The study concluded that 33% of the total costs of the headquarters project were determined to be section § 1245 property.

The taxpayer capitalized interest expense under § 263A(f) with respect to the headquarters project during 1997 and 1998. In its calculations, the taxpayer determined its accumulated production expenditures (APEs) at each monthly measurement date by totaling the costs of the headquarters project incurred through the measurement date and subtracting 33% of such costs to reflect the costs of section

1245 property, which taxpayer argues should be excluded from the APEs.

The examiner believes that certain costs identified by the taxpayer as section 1245 property were real property for purposes of § 263A(f), and should not have been excluded from the APEs of the headquarters buildings. The examiner also argues that the taxpayer's method of determining its APEs on various measurement dates -- applying the same overall exclusion percentage to determine APEs on all measurement dates – is incorrect; the portion of costs excluded from the APEs must be separately determined on each measurement date.

LAW AND ANALYSIS:

ISSUE 1. Whether the measurement dates used in the calculation of capitalized interest under § 263A(f) constitute a method of accounting to which the provisions of sections 446 and 481 and the regulations thereunder apply.

Section 1.263A-9(f)(2)(i) prescribes general rules for the choice of permissible measurement dates, and provides that a taxpayer is permitted to modify the frequency of measurement dates from year to year.

Under § 1.263A-9(f)(2), a taxpayer is permitted to modify its choice of measurement dates from one taxable year to another. Any such change is not a change in method of accounting to which the provisions of sections 446 and 481 and the regulations thereunder apply. Preamble, T.D. 8584, 1995-1 C.B. 20, 24. A taxpayer is thus not required to seek the consent of the Commissioner pursuant to § 446(e) before changing its measurement dates.

However, once a taxpayer has chosen its measurement dates and has filed its returns on that basis for a taxable year, the doctrine of election generally prohibits the taxpayer from subsequently altering its choice of measurement dates. The doctrine of election, as it applies to Federal tax law, consists of two elements: (i) a free choice between two or more alternatives, and (ii) an overt act by the taxpayer communicating the choice to the Commissioner; i.e., a manifestation of choice. A taxpayer who makes such an election may not, without the consent of the Commissioner, retroactively revoke or amend it merely because another alternative now appears to be more advantageous. Pacific National Co. v. Welch, 304 U.S. 191 (1938); J. E. Riley Inv. Co. v. Commissioner, 311 U.S. 55 (1940); Bayley v. Commissioner, 35 T.C. 288, 298 (1960); Grynberg v. Commissioner, 83 T.C. 255, 261 (1984); Hodel v. Commissioner, T.C.Memo. 1996-348.

In this case, the taxpayer had a free choice of measurement dates for each taxable year, and it communicated its choices to the Commissioner by means of its filed returns. Absent some special circumstances (which do not appear in the facts submitted), the taxpayer is thus bound by its choices of measurement dates, and

cannot modify such choices after they are made.

ISSUE 2: Whether an item classified as tangible personal property for purposes of the definition of “section 1245 property” can ever constitute “real property” as defined in § 1.263A-8(c).

Section 263A(f)(1) provides that § 263A(a) shall only apply to interest costs which are: (A) paid or incurred during the production period; and (B) allocable to real or tangible personal property produced by the taxpayer that has a long useful life, has an estimated production period exceeding two years, or has an estimated production period exceeding one year with a cost exceeding $1,000,000. Section 263A(f)(4)(A) provides that property has a long useful life if such property is real property or property with a class life of 20 years or more (as determined under § 168).

Section 1.263A-8(c)(1) provides that real property includes land, unsevered natural products of land, buildings, and inherently permanent structures. Real property includes the structural components of buildings and inherently permanent structures, such as walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property.

Section 1.263A-8(c)(3) provides that inherently permanent structures include property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time, such as swimming pools, roads, bridges, tunnels, paved parking areas and other pavements, special foundations, wharves and docks, fences, inherently permanent advertising displays, inherently permanent outdoor lighting facilities, railroad tracks and signals, telephone poles, power generation and transmission facilities, permanently installed telecommunications cables, broadcasting towers, oil and gas pipelines, derricks and storage equipment, grain storage bins and silos. Property may constitute an inherently permanent structure even though it is not classified as a building for purposes of former §§ 48(a)(1)(B) and 1.48-1. Any property not otherwise described in § 1.263A-8(c)(3) that constitutes other tangible property under the principles of former §§ 48(a)(1)(B) and 1.48-1(d) is treated for the purposes of § 1.263A-8 as an inherently permanent structure.

For the taxable years involved, a cost segregation study was typically done by a taxpayer to determine whether depreciable property is section 1245 property or section 1250 property for purposes of § 168. Section 168(i)(12) provides that the terms “section 1245 property” and “section 1250 property” have the meanings given such terms by §§ 1245(a)(3) and 1250(c), respectively.

Section 1245(a)(3) provides that the term "section 1245 property" means any property which is or has been property of a character subject to the allowance for depreciation provided in § 167 and is either: (A) personal property; (B) other property (not including a building or its structural components) but only if such other property is

tangible and is used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or constituted a research facility, or a bulk storage facility of fungible commodities, used in conjunction with any of the foregoing activities; (C) so much of any real property (other than any property described in subparagraph (B)) which has an adjusted basis in which there are reflected adjustments for amortization under § 169, 179, 179A, 185, 188 (as in effect before its repeal by the Revenue Reconciliation Act of 1990), 190, 193, or 194; (D) a single purpose agricultural or horticultural structure (as defined in § 168(i)(13)); (E) a storage facility (not including a building or its structural components) used in connection with the distribution of petroleum or any primary product of petroleum; or (F) any railroad grading or tunnel bore (as defined in § 168(e)(4)).

Section 1.1245-3(b) provides that the term "personal property" means (1) tangible personal property (as defined in § 1.48-1(c), relating to the definition of "section 38 property" for purposes of the investment credit), and (2) intangible personal property.

Section 1.48-1(c) provides that the term "tangible personal property" means any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures). Thus, buildings, swimming pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property. Tangible personal property includes all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which is contained in or attached to a building constitutes tangible personal property. Further, all property which is in the nature of machinery (other than structural components of a building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property.

Section 1.48-1(c) further provides that local law shall not be controlling for purposes of determining whether property is or is not “tangible “ or “personal.” Thus, the fact that under local law property is held to be personal property or tangible property shall not be controlling, and that property may be personal property for purposes of the investment credit even though under local law the property is considered to be a fixture and therefore real property.

Section 1.48-1(e)(2) provides that the term "structural components" includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors; all

components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building. However, the term "structural components" does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the "sole justification" test provided by the preceding sentence even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential.

In Hospital Corporation of America v. Commissioner, 109 T.C. 21 (1997) ("HCA"), the Tax Court concluded that tests developed for purposes of the investment credit ("ITC") under former § 48 could be used by taxpayers to distinguish section 1245 property from section 1250 property for purposes of § 168. Consequently, depreciable property that would have qualified as tangible personal property for ITC purposes also will qualify as section 1245 property for depreciation purposes. Id. at 55.

By contrast, the legislative history of § 263A(f), contains nothing to indicate that Congress intended the broad construction of tangible personal property under the ITC to apply to interest capitalization under § 263A(f). Accordingly, the classification of property as tangible personal property for purposes of former § 48 should not be determinative of the classification of property as tangible personal property for purposes of § 263A(f). Preamble, T.D. 8584, 1995-1 C.B. 20, 22. Thus, the fact that electrical lines within a building might be classified, in whole or in part, as tangible personal property for purposes of the definition of § 1245 property does not determine whether these lines are tangible personal property or real property for purposes of § 263A(f).

From the foregoing, it follows that the principles and tests used to determine whether an item of property is tangible personal property under § 1.48-1(c) (and thus to determine whether the item qualifies as section 1245 property) do not apply in determining whether such item of property is tangible personal property or real property for purposes of § 263A(f). For example, the principle that the classification of property under local law is irrelevant to the classification of property for purposes of the ITC (and section 1245 property) does not apply to the classification of property under § 263A(f). In the absence of any applicable legislative direction to ignore the status of property under local law in the context of § 263A(f), we believe that the local law characterization of an item of property can be a relevant consideration in the classification of property as either tangible personal property or real property for purposes of § 263A(f).

As a further example, under the ITC classification of property, a number of courts have concluded that an item of property, even if listed in § 1.48-1(e)(2), is not a structural component of a building to the extent that the item does not relate to the operation or maintenance of the building. *See, e.g.,* Scott Paper Co. v. Commissioner, 74 T.C. 137 (1980); HCA; *but see* Boddie-Noell Enterprises, Inc. v. United States, 36 Cl. Ct. 722 (1996). As a result, even though wiring is an example under § 1.48-1(e)(2), some courts have allocated the cost of electric wiring based on its ultimate use: the portion of the wiring representing the electrical load necessary for the operation of, and used directly with, particular pieces of machinery within the building, is tangible personal property, and the portion of wiring representing the electrical load related to the operation or maintenance of the building is a structural component. *See, e.g.,* Scott Paper Co.; HCA.

As discussed above, the foregoing test does not control the classification of property under § 263A(f). In the absence of such a controlling test, an item of property that does not qualify as a structural component under the ITC scheme because it does not relate to the operation or maintenance of a building may well constitute a structural component of the building, and thus real property, under § 1.263A-8(c) if the property otherwise possesses sufficient indicia of being a structural component under that regulation, such as being described as such within § 1.263A-8(c), being permanently attached, and qualifying as a fixture under local law. For example, electrical wiring in a building could qualify as a structural component under § 1.263A-8(c) regardless of its ultimate use.

Finally, we note that the taxpayer objects to the capitalization of interest with respect to items classified as tangible personal property under the definition of section 1245 property on the grounds that the interest thus capitalized would not be depreciated using the depreciation method, recovery period, and convention applicable to such property under § 168; instead, it would be depreciated using the depreciation method, recovery period, and convention applicable to nonresidential real property. We do not believe that Taxpayer's objection represents an accurate reading of the regulations under § 263A(f).

Interest capitalized under § 263A(f) is treated as a cost of the designated property produced, and is recovered through depreciation, amortization, cost of goods sold, or an adjustment to basis at the time the property is used, sold, placed in service, or otherwise disposed of by the taxpayer. Cost recovery is determined by the applicable Code and regulatory provisions relating to the use, sale, or disposition of property. Sections 1.263A-1(c)(4) and 1.263A-8(a)(2).

The regulations further provide that interest capitalized with respect to the produced designated property that includes both components subject to an allowance for depreciation or depletion and components not subject to an allowance for depreciation or depletion is ratably allocated among, and is treated as a cost of,

components that are subject to an allowance for depreciation or depletion. Section 1.263A-8(a)(2). We believe that this principle of ratable allocation applies equally well to interest capitalized with respect to the produced designated property that includes only components subject to an allowance for depreciation.

Accordingly, interest capitalized under § 263A(f) with respect to a unit of designated property is ratably allocable to the components of property comprising the unit. Thus, interest capitalized with respect to items classified as tangible personal property under the definition of section 1245 property would be allocated to such property, and would be depreciated under the Code and regulatory provisions applicable to such property.

ISSUE 3. Whether components of tangible personal property and components of real property may combine to form a single unit of property within the meaning of § 1.263A-10.

Section 1.263A-10(b)(1) provides that a unit of real property includes any components of real property owned by the taxpayer or a related person that are functionally interdependent and an allocable share of any common feature owned by the taxpayer or a related person that is real property, even though the common feature does not meet the functional interdependence test.

Section 1.263A-10(b)(2) provides that components of real property produced by or for the taxpayer, for use by the taxpayer or a related person, are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component by the taxpayer or a related person.

Section 1.263A-10(b)(3) provides that a common feature generally includes any real property (as defined in § 1.263A-8(c)) that benefits real property produced by, or for, the taxpayer or a related person, and that is not separately held for the production of income

Section 1.263A-10(c) provides that components of tangible personal property are a single unit of property if the components are functionally interdependent. Components of tangible personal property that are produced by, or for, the taxpayer, for use by the taxpayer or a related person, are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component by the taxpayer or a related person.

The regulations under § 263A(f) contemplate that interest capitalization calculations should be done on the basis of a "unit of property" as defined in § 1.263A-10. A unit of property may consist of multiple "components" of property. Thus, a unit of property in a housing development may consist of a house, the associated land, and an allocable share of any common features such as a roadway. § 1.263A-10(b)(6),

Example (1).

The regulations under § 263A(f) contemplate two types of property components: real property (defined in § 1.263A-8(c)), and tangible personal property (defined in § 1.263A-2(a)(2)). The regulations provide that real property components may combine into a single property unit (§ 1.263A-10(b)(1)), and that tangible personal property components may combine into a single property unit (§ 1.263A-10(c)). No provision is made, however, for real property components and tangible personal property components combining into a single property unit. Accordingly, a unit of property under § 1.263A-10 must either be a real property unit (consisting entirely of real property components) or a tangible personal property unit (consisting entirely of tangible personal property components).

The taxpayer undertook a large project to build and equip a new corporate headquarters. This project consisted of many differing property components, some of which would be classified as "real property" under § 1.263A-10(b)(1) and some of which would be classified as "tangible personal property" under § 1.263A-2(a)(2)). As a result, the project could not constitute a single unit of property for purposes of § 263A(f); instead, the project consists of one or more units of real property and one or more units of tangible personal property. The determination of which units aggregate into a particular unit of property is made using the functional interdependence concept introduced in §§ 1.263A-10(b)(2) and 1.263A-10(c).

ISSUE 4. Whether taxpayer's use of the same overall exclusion percentage to determine the amount of costs excludable from its accumulated production expenditures on each measurement date was proper.

Section 1.263A-9(a)(2)(i) provides that for each unit of designated property (within the meaning of § 1.263A-8(b)), the avoided cost method requires the capitalization of the traced debt amount under § 1.263A-9(b) and the excess expenditure amount under § 1.263A-9(c).

Section 1.263A-9(c)(1) provides that for each unit of designated property, the excess expenditure amount for a computation period equals the product of the average excess expenditures (as determined under § 1.263A-9(c)(5)(ii)) for the unit of designated property for that period, and the weighted average interest rate (as determined under § 1.263A-9(c)(5)(iii)).

Section 1.263A-9(c)(5)(ii) provides that the average excess expenditures for a unit of designated property for a computation period are computed by determining the amount (if any) by which accumulated production expenditures exceed traced debt at each measurement date during the computation period, and dividing the sum of these amounts by the number of measurement dates during the computation period.

Section 1.263A-9(d)(1) provides that taxpayers may elect not to trace debt. If such election is made, the average excess expenditures and weighted average interest rate under § 1.263A-9(c)(5) are determined by treating all eligible debt as nontraced debt.

The examiner objects to the following method used by the taxpayer to determine it accumulated production expenditures (APEs) for the corporate headquarters project on the various measurement dates. The taxpayer bases its APE calculation on an account that contains many different types of costs related to the headquarter project, some of which are APEs and some of which are not. On completion of the project, the taxpayer determined that X% of the total costs in that account were APEs. The taxpayer then determined APEs on each measurement date by multiplying the balance of the account on that date by X%.

The foregoing is not a proper method for determining the APEs on the various measurement dates of the project. The taxpayer's method would yield a correct result only in the rare circumstance where the percentage of account costs included in the APEs remained perfectly constant from the beginning of the project to the end. More typically, the percentages of account costs included in APEs on the various measurement dates will vary, and will differ from the percentage of the total account costs included in APEs at the end of the project. Accordingly, the taxpayer's method does not provide an acceptable means for determining, or even estimating, the APEs on the various measurement dates.

Finally, from the limited facts provided, we note that the taxpayer's method probably understates APEs as applied to this particular project. The percentage of account costs included in APEs would be relatively high in the beginning of the project, when most of the costs in the account would relate to land and the construction of the building. The percentage would gradually fall as the project reached completion and more costs for tangible personal property such as furniture were added to the account. The percentage would reach its lowest point at the end of the project. Under this scenario, the method used by the taxpayer understates the APEs on the various measurement dates because the final (and lowest) percentage of account costs allocable to APEs is projected back on all of the measurement dates over the life of the project.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.